Statement of Congressman Michael N. Castle

Financial Services Committee hearing on
Hedge Funds and Systemic Risk in the Financial Markets

March 13, 2007

Thank you Chairman Frank and Ranking Member Bachus for holding this important hearing before the Financial Services Committee today.

Last month the Under Secretary for Domestic Finance at the Department of Treasury, Secretary Steele, reported on the tremendous influence hedge funds are having on our markets. The President's Working Group discussed how the number of hedge funds has more than doubled in the last five years, growing to over 9,000 funds today. Since their last study in 1999, the industry has grown by more than 400% totaling nearly $1.4 trillion. Last year, the combined assets of the 100 largest hedge fund firms represented about 65% of the total industry. Secretary Steele further explained the vast amount of trading volume hedge funds are generating, and speculated that they may represent up to 50% of trading in particular instances. The Treasury also discussed how institutional investors, like pension funds, constitute more than half of investments in hedge funds.

With pension funds placing more of their money in hedge funds workers, retirees, and other average investors may unknowingly be exposed to hedge fund losses. The President's Working Group recommended that investors in hedge funds gather necessary information regarding the fund's "strategies, terms, conditions and risk management" to make informed investment decisions and perform due diligence. Yet, hedge funds are not legally required to disclose this information. I am concerned with this lack of transparency, because the manager of a pension fund cannot fulfill their fiduciary duty and may not understand the risk of their investments to perform due diligence before committing funds.

This lack of transparency in the industry also poses systemic risk to the financial markets. The Long-Term Capital Management incident showed how overexposure of counterparties has the potential to cause system wide damage to financial markets.

After Long-Term Capital Management incident, the Federal Reserve expressed concerns about the systemic risk hedge funds pose to the financial markets. At that time, the President's Working Group recommended that the very largest hedge funds be required to disclose information about their financial activities, including meaningful and comprehensive measures of market risk. The Working Group now concludes that no government agency needs any information about hedge fund activities, and that we can rely on hedge fund investors themselves to protect the markets from systemic risk. It is unclear to me why the Treasury now appears a lot less cautious than they were in 1999, since the industry has grown considerably.

During the last Congress, I introduced legislation requesting the President's Working Group on Financial Markets to conduct a study on this evolving industry and make certain recommendations regarding hedge fund disclosure based on this information. The bill passed the House however it was not introduced in the Senate. I will continue to follow the developments in the House Financial Services Committee pertaining to hedge funds and determine if it is necessary to legislate in this area.

Mr. Chairman, I thank you for holding this important hearing today and I look forward to hearing from our witnesses and learning more about this industry.